

“SPAIN IS DIFFERENT”

by Dr. Daniel C. Denby, Managing Director
– REDIRECTION. S.A.
Madrid – Spain

The title of this article, although usually applied to Spain's sunny climate, friendly people, and their ways of looking at things, also most definitely applies to its business practices. After a general introduction, this article will highlight the major differences between doing business in Spain, and the rest of Western Europe and/or the United States, particularly as it applies to cross-border mergers, acquisitions and divestitures.

Spain – General

On 1st January 1986, Spain joined the European Common Market (EEC) after being virtually closed to foreign competition for more than fifty years. This sophisticated consumer market of thirty-eight million indigenous population, and forty-three million foreign tourists annually, with the world's tenth largest GNP, can no longer be seriously ignored by any internationally-minded company.

EEC entry is of considerable concern to Spanish industry since their domestic markets are now open to outside competition, and they will have to place substantially more emphasis on selling internationally. Most Spanish companies have been considering how to meet these challenges, and this has created an enormous interest in associating with foreign firms. For example, we were recently retained by a British public company to locate a Spanish acquisition in a specific engineering industry. Our research turned up 65 such companies; and of these, 35 indicated an interest in opening conversations with our client.

Today, Spanish industry is characterised by small and medium-sized, privately-owned companies. Many of these are not efficient by EEC standards and will have to modernise and rationalise in order to be competitive. Unfortunately the financial markets in Spain are not as well developed as in the rest of western Europe and the United States: the stock markets are currently reserved for only the largest of companies, there is no venture capital industry, and banks are extremely conservative in their lending. For example, almost all bank loans to private companies are mortgage-based, and if a company does not possess enough real-property, the loans are usually guaranteed by the shareholders' personal real-property assets.

In summary, raising capital within Spain today necessary for modernisation and growth, is extremely difficult; and because of this, one will soon witness an enormous number of mergers among Spanish firms, acquisitions by foreign companies, and bankruptcies of those companies unable to adapt.

Market Potential

Spain is Europe's second largest country and one of its least densely populated. It offers tremendous potential for growth, even in traditional market sectors usually considered mature in the rest of Europe. As examples: there are only 24 automobiles for each 100 inhabitants, compared to 32 in the rest of the EEC; and these cars average 12 years old. Similarly, Spain has only 36 telephones for each 100 people versus 42 for the EEC; and 26 televisions versus 35. Spain's annual chocolate consumption (one kilo per capita) offers ample room for growth when



Dr. Daniel C. Denby

compared to the rest of the EEC (5 kilos); and even Spain's annual tissue paper consumption (4 kilos per capita), shows unfulfilled potential next to the UK (8 kilos) and Germany (10 kilos).

There is already a very large foreign presence in Spanish industry. For example, foreign firms now control about 50% of Spain's £16 billion a year food industry, and this will probably soon increase to 90%. Some two-thirds of the pharmaceutical industry is controlled by foreign companies and all six automobile manufacturers are now foreign controlled. Furthermore, although Spain has so far only been Europe's fourth largest destination for investment by Japanese manufacturing companies (where 26 firms are already represented); *IT IS NUMBER ONE IN TERMS OF JAPANESE PROFITABILITY IN EUROPE.*

One frequently overlooked advantage of Spain is its very close traditional trade links with Spanish-speaking Central and South America. Therefore, acquiring a Spanish company could facilitate the opening of these markets as an added bonus.

One surprising aspect of Spanish industry is the small size of its companies. Our firm frequently receives enquiries from the US or UK indicating interest in acquisitions with minimum annual sales turnovers of say £25 million or £50 million in a specific industry. Unfortunately, there are not that many companies of such size in each Spanish industry! For example, a ranking of ALL Spanish companies by annual sales turnovers puts the 500th with a turnover of about £30 million; whereas the same ranking in the UK has the 500th with a turnover figure of about £115 million. As a result, it is common to find a company

in Spain, with an extremely dominant position in a specific market sector (say 75%), with an annual sales turnover figure of £5 million.

It is rare to find a high technology-oriented company in Spain which is not already associated in some way or another with a large foreign firm. Therefore, trying to locate an unattached high technology Spanish company to acquire is almost futile. Nevertheless, a foreign company already possessing technology, wishing to attack the Spanish market by transferring this technology and setting up a manufacturing or assembly base, would find enormous acceptance.

Very few companies in Spain have ever bothered to set up in-house pension schemes, primarily because contributions by a company have not been a tax deductible expense; and any contribution would also have been considered as income to the beneficiary at the same time of contributing to the scheme. However starting next year, new legislation will go into effect allowing tax-effective pension plans, as long as they are administered by independent firms. Since such firms do not currently exist within Spain, this will essentially create a new financial services industry, as well as significantly strengthen Spain's very underdeveloped insurance business. (*Spain has about 600 insurance companies, more than 75% of which have annual premium incomes of less than £3 million*).

Furthermore, in addition to streamlining admission requirements and modernising Spain's stock markets, a parallel stock market will be set up similar to the UK's U.S.M. or the US's O.T.C. This will certainly facilitate the raising of capital by medium-sized companies, and sow the seeds for a venture capital industry.

Since the liberalisation of Spain's banking laws several years ago, close to 50 foreign banks have rushed in to capitalise on one of Europe's most intensively banked countries (with one branch per 1,500 people). American and European banks are now busily acquiring Spanish banks or setting up joint ventures. For example, Citibank now has about 75 Spanish branches; Barclays, more than 50; and National Westminster, more than 80.

Investment Climate

Many of the old protectionist laws in Spain regarding imports and foreign investment have been either completely dropped or eased considerably. They will continue to be further relaxed during the next seven years as Spain gradually becomes a fully-integrated member of the EEC. Today there are few restrictions on foreign ownership of Spanish companies. Except for six protected industries (eg. defence, public services, radio, television, gambling and airlines), a foreign firm can acquire up to 100% of Spanish company with a minimum of "red tape", the whole process taking about 30 days.

Furthermore, *AS LONG AS A FOREIGN INVESTMENT IS PROPERLY DECLARED WHEN IT IS MADE*, there are no difficulties in exporting dividends; and if the investment is eventually sold or liquidated, the original investment and all capital gains can also be easily repatriated (after paying the appropriate taxes).

Now, the climate for foreign investment could not be better. For example, General Motors' very modern Spanish plant is the largest investment in its history outside of the US. This certainly would not have occurred without a great deal of study and faith in Spain's future.

Taxation

The corporation tax rate on profits in Spain (currently 35%) is one of the lowest in the E.E.C. There are also fairly liberal investment tax credits, accelerated depreciation allowances, and tax-free treatment of some profits for future investment. Furthermore, depending on the type of investment and where it will be made, many government grants and tax incentives are available, particularly if jobs are to be created.

Personal income tax rates are also low when compared with other EEC countries. A graduated scale is applied, with the top rate (currently 46%) coming into effect at a taxable annual income of approximately £60,000.

Spain has also entered into many tax treaties with EEC and other industrialised countries, to avoid double taxation of both corporate and personal incomes.

To comply with EEC regulations, Spain recently introduced a Value Added Tax which replaced some 25 other indirect levies. There are three rates: 6%, 12% and 33%. The 12% rate is the most frequent, with 6% applied to food and other necessary items, and 33% being primarily for luxury items.

Politics

Since the successful introduction of democracy (a constitutional monarchy) in 1976, Spain has been very stable politically, except for a minor separatist movement in the Basque country. In 1982, a pro-industry socialist government took over which has so far made significant strides. It must be pointed out, however, that socialism in Spain (being slightly left of centre), is very different to what one sees in the UK or France, since there is no tendency whatsoever to nationalise companies.

Employment

The Spanish work-week is 40 hours. Unemployment in Spain is currently one of the highest in Europe, standing at close to 20%.

Although Spanish salaries are low when compared with the rest of the EEC (except Greece and Portugal), the social charges are fairly high (close to 40%). Nevertheless, even when these charges are taken into account, Spain is still a low-cost manufacturing base.

Even though socialist governments generally show favoritism towards the *EMPLOYEE*, these policies are not particularly onerous to the *EMPLOYER* in Spain. Of course it is as difficult and expensive to fire someone as in the rest of Europe, but even this is usually negotiable with the employee. (Current legislation calls for six weeks salary for each year of service).

Merger & Acquisition Activity

Since only about 325 companies are quoted on the Spanish stock exchanges, most merger and acquisition activity is concentrated among private, closely-held companies, usually family-owned.

The Spanish Merger & Acquisition professional services industry is very small today. There are less than 10 independent professional firms in Spain acting as Merger & Acquisition brokers/consultants on a full-time basis; and perhaps another 10 merchant and investment banks which also get involved from time to time.

Unfortunately it is impossible to give reliable statistics on the

number of acquisitions (both domestic and/or cross-border) and the prices or multiples paid. This is due primarily to the excessive secrecy of Spanish companies and the resulting dearth of reliable company information. This information gap should improve as Spain becomes more integrated into the EEC. As a subjective comment however, suffice it to say that it is rare to pay high multiples of earnings for Spanish manufacturing-companies. A typical transaction is likely to be moderately above or below Net Asset Value, depending on whether the company is profitable or not.

Nevertheless, owners of Spanish companies tend to place unrealistically high initial asking prices on their companies.....but our experience shows that these turn out to be extremely negotiable.

Accounting & Financial Practices

Perhaps the biggest difference between Spain and other industrialised countries is in its accounting and financial practices. Although what will be mentioned below holds true today; it is rapidly changing as Spain becomes more integrated into the EEC.

* Privately-owned Spanish firms are extremely secretive about their financial data because they usually keep two sets of books.....one for the shareholders, and the other for the tax authorities. Hence, even if an owner is quite keen to sell his company, he is very reluctant to reveal even the most basic financial data, until after a personal meeting.

* The typical presentation of a Spanish company's Balance Sheets and Profit & Loss Statements is usually alien to a foreign buyer and his financial advisors. For example, past losses, instead of being subtracted from reserves on the liability side of the Balance Sheet, are *SOMETIMES* put as a positive number on the asset side. Similarly, accumulated depreciation, instead of being subtracted from the fixed assets' acquisition costs, are *SOMETIMES* put as a positive number on the liability side, as a reserve. Hence, one must be perfectly clear about the basis of calculation when speaking of Total Assets or Net Asset Value within Spain.

* If they think they can get away with it, privately-owned Spanish firms frequently pass off capital investment in tools, machinery, etc., as current expenditures (thereby writing off the full amount in the first year to save on taxes). Therefore, when an unknowing foreign buyer evaluates a Spanish company's Balance Sheets and Profit & Loss Statements, too low estimates are usually placed upon the company's Fixed Assets, not to mention its profit history.

* Audits in Spain are more the exception than the rule. By law, only companies quoted on the stock markets need their books audited. Even companies with a large number of shareholders are not required to be audited. For example, we are aware of a company having an annual sales turnover of £20 million, with 700 shareholders, whose accounts are not audited.

Surprisingly, even Spanish banks do not usually require audited accounts from a company when applying for a loan. This dearth of audits is motivated primarily by cost and the lack of legislation. Nevertheless, there are never objections to an audit of an acquisition candidate (if paid for by the potential acquirer).

* Companies need not file their accounts with a central register unless they are publicly-held. That is to say there is no equivalent in Spain to the UK's "Companies House". Although some commercial informative sources do exist, information is usually not reliable and this of course makes M & A searches very tedious.

* Spanish companies tend to work with many banks. It is not uncommon for a small or medium-sized company to have twenty current accounts with as many banks.

* Most Spanish companies' purchases or sales are transacted with promissory notes or bills of exchange ("letras"), usually requiring payment in 30, 60 or 90 days. The common practice, particularly for small, privately-owned, undercapitalised companies, is to discount these notes before their maturity to ease cash flow problems. Therefore when someone unaware of this practice examines a Spanish company's accounts, they are surprised to discover inordinantly high finance charges on the P&L, in relation with the loan obligations on the Balance Sheet.

* Although this would never be allowed in most other EEC countries, and it is getting much harder to do in Spain, Spanish companies frequently run up enormous debts with public bodies. Obligations for social security payments, sales taxes, and employee withholding taxes, can sometimes accumulate for three or four years without radical action by the agencies involved. Essentially these companies are using government money for finance.

When the public entities do crack down, they are usually fairly lenient in negotiating repayment terms. If the companies promise to pay their current obligations, it is not unusual to negotiate a three to five year payment schedule, with minimum interest, for all past unpaid obligations.

* Unlike the UK, Spain has very similar legislation to the US's "Chapter 11" - called "Suspension de Pagos". If a Spanish company runs out of cash, but can prove to the courts that the value of its assets is significantly more than its liabilities, it can ask for protection from its creditors.

Essentially what happens is that the *ENTIRE* liability side of the Balance Sheet is frozen. The company continues trading, paying cash for its supplies, and payment terms are then negotiated with the creditors for the past debts. These payment terms are usually very favourable. For example, one of our clients negotiated an eleven year payment schedule, at no interest, with an initial four-year payment moratorium. When analysed in present value terms, this means that the company will pay only 36% of its obligations at the time of the declaration. Obviously, acquiring a company in "Suspension de Pagos" can be extremely attractive in that *ALL OF ITS PREVIOUS DEBT WILL HAVE BEEN TRANSFORMED INTO LONG TERM DEBT*.

* One progressive step taken by Spain some years ago, was to institute a national chart of accounts (similar to France's). All limited companies must organise their accounts according to this plan; and whilst this may seem quite restrictive to the uninitiated, it is just the opposite. There is sufficient flexibility to allow all companies, no matter what their size or activity, to present their accounts as they wish; yet enable anyone familiar with this simple coding system, to feel immediately at home looking at any company's accounts.

Taking Advantage of the Opportunity

It should be evident from this article that Spain represents both an enormous opportunity as well as a challenge to the foreign investor. Any company without Spanish business experience, must be careful not to extrapolate experience gained in its own, or other countries; and it is advised that when considering a Spanish merger or acquisition, professional advice be obtained from someone totally familiar with Spanish legislation and business practices, and how they differ from the rest of the EEC.

REDIRECTION, S.A.

José Abascal 45; Madrid 28003; Spain;
Telephone (34-1) 442-4733; Telex 23829 GGEX E